

WALGREENS & TRIPLE NET LEASES



Presented By:

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Introduction

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Does your county have one of these properties?



These are just a few of the companies that typically sign net leases. Although this presentation is specific to drugstores, the same methodology will apply to these properties and those leased by similar tenants on a net lease basis. The outcome of upcoming KBTA cases could seriously impact the value of these types of properties all across the state.

What's Really At Stake

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Your county's tax roll and revenue

Let's use the current cases at the KBTA as example:

- \$69,000,000 on the table
- Assume 1% tax rate
- \$690,000 in missing real revenue
 - \$448,500 to Board of Education
 - \$84,180 to Commonwealth of KY
- Multiply this by brands, by counties, and by years.
The impact is remarkable.

Outline

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This workshop will discuss:

- Terms You Should Know
- Fee Simple vs. Leased Fee
- Income Approach to Value
- Methodology of Net Leased Drugstore Valuation
- Market Rent vs. Contract Rent
- History of Appeals
- KBTA Decision Possibilities

Terms You Should Know

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Fee Simple Estate – Absolute ownership unencumbered by any other interest or estate

Leased Fee Estate – An ownership interest held by a landlord with the right of use and occupancy conveyed to others by lease.

Terms You Should Know

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Leasehold Estate – The interest held by the lessee (the tenant or renter) through a lease conveying the rights of use and occupancy for a stated term under certain conditions.

Net Lease – A lease in which the tenant pays all property operating expenses in addition to the stipulated rent.

Terms You Should Know

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Market Rent— The rental income that a property would most probably command in the open market; indicated by the current rents asked and paid for comparable space.

Contract Rent— The actual rental income specified in a lease.

Fee Simple vs. Leased Fee

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Fee Simple

Under fee simple the property rights appraised are in fee simple title ownership, assuming no liens or encumbrances other than normal covenants and restrictions of record such as zoning and real estate taxes.

As defined in the thirteenth edition of *The Appraisal of Real Estate* as published by the Appraisal Institute, fee simple title means absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power and escheat. This would typically be the property rights addressed when appraising, for instance, an owner-occupied commercial building.

Fee Simple vs. Leased Fee

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Leased Fee

Under leased fee estate, we are addressing the lessor's, or landlord's interest. This would be performed when the subject property is encumbered by the existence of long-term leases.

As defined in the thirteenth edition of *The Appraisal of Real Estate* as published by the Appraisal Institute, leased fee estate means an ownership interest held by a landlord with the rights of use and occupancy conveyed by lease to others. The rights of the lessor (the leased fee owner) and the lessee are specified by contract terms contained within the lease. This would typically be the property right addressed when appraising, for instance, a multi-unit office building with a series of long-term tenants.

Fee Simple vs. Leased Fee

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- The typical interest for most single tenant properties that are being valued is the leased fee interest. The valuation of this type of interest is the most appropriate method for determining the fair cash value of the property.
- Kentucky Revised Statutes and the Kentucky Constitution say, “All property, not exempted from taxation by this Constitution, shall be assessed for taxation at its fair cash value, estimated at **the price it would bring at a fair voluntary sale.**”
- The fair cash value can represent the value for any interest in the property and not just the fee simple value. The fair cash value for single tenant properties should be based upon the leased fee interest valuation.

Fee Simple vs. Leased Fee

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Major Differences Between Leased Fee and Fee Simple Valuation Single Tenant Properties		
	Leased Fee	Fee Simple
Rent	Contract (Actual)	Market
Vacancy	Actual (None on Single Tenant Properties)	Market
Expenses	Actual (Typically none on Single Tenant properties because they are triple net or absolute net leased which means the tenant pays the expenses.)	Market
Capitalization Rate	Typically lower than fee simple due to a long term lease and is less risky because of the guaranteed income stream and the typically strong credit worthiness of the tenant.	Typically higher than leased fee due to the uncertainty of the income stream.

Methodology of Net Leased Drugstore Valuation

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The best way to value the net leased drugstore properties is through a combined use of the sales comparison and income approaches to value.

The sales comparison approach will be used less as a means of valuation and more to help us supplement the information we need to utilize the income approach.

The sales can then be used as a means to check our work to make sure the number we reach using the income approach is in line with actual sales figures.

Methodology of Net Leased Drugstore Valuation

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The Sales Comparison Approach

Below is a table of sales of a particular drugstore chain in KY and all bordering states from May 2011 to September 2013.

Address	Sale Date	Sale Price
2655 Frayser Blvd., Memphis, TN	9/17/2013	\$6,578,000
1945 Lincolnway East, South Bend, IN	8/31/2013	\$9,035,354
2285 Versailles Rd, Lexington, KY	8/22/2013	\$4,916,598
6202 W. Jefferson St., Fort Wayne, IN	6/20/2013	\$5,985,820
1303 Copley Rd., Akron, OH	6/6/2013	\$2,575,000
9290 Wicker Ave., St. John, IN	3/24/2013	\$3,530,000
720 N. Broadway St., Peru, IN	1/17/2013	\$4,565,000
429 N. State Of Franklin Rd., Johnson City, TN	12/21/2012	\$7,377,000
4071 Lee Rd., Cleveland, OH	11/13/2012	\$4,800,000
20 W. Main St., Brownsburg, IN	7/12/2012	\$3,520,000
2001 Sunset Blvd., Steubenville, OH	6/15/2012	\$4,550,000
775 Wenger Road, Englewood, OH	1/20/2012	\$4,735,000
537 W. Main Street, Xenia, OH	10/31/2011	\$5,575,244
1201 Getwell Road, Memphis, TN	10/26/2011	\$4,853,412
1400 Cassapolis, Elkhart, IN	7/31/2011	\$5,040,000
1801 N. Main Street, Madisonville, KY	6/29/2011	\$4,202,333
1415 Liberty Pike, Franklin, TN	5/12/2011	\$4,442,029

Methodology of Net Leased Drugstore Valuation

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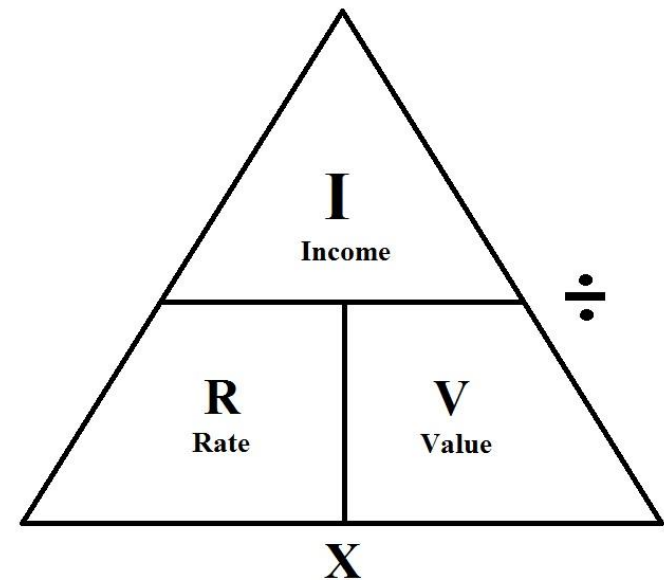
Income Approach:

Remember IRV:

- $\text{Income} / \text{Rate} = \text{Value}$
- $\text{Value} \times \text{Rate} = \text{Income}$
- $\text{Income} / \text{Value} = \text{Rate}$

Using IRV and the previously mentioned comparable sales we can extract all the information

we need to successfully apply the income approach to the subject property.



Methodology of Net Leased Drugstore Valuation

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Using IRV in conjunction with our comparable sales we are able to produce verifiable market-extracted information that becomes one of the two main components of the drugstore valuation formula.

Address	Sale Date	Sale Price	OAR - Actual	Net Income
2655 Frayser Blvd., Memphis, TN	9/17/2013	\$6,578,000	5.75%	\$378,235
1945 Lincolnway East, South Bend, IN	8/31/2013	\$9,035,354	6.09%	\$550,253
2285 Versailles Rd, Lexington, KY	8/22/2013	\$4,916,598	N/A	N/A
6202 W. Jefferson St., Fort Wayne, IN	6/20/2013	\$5,985,820	7.76%	\$464,500
1303 Copley Rd., Akron, OH	6/6/2013	\$2,575,000	8.76%	\$225,570
9290 Wicker Ave., St. John, IN	3/24/2013	\$3,530,000	8.10%	\$285,930
720 N. Broadway St., Peru, IN	1/17/2013	\$4,565,000	6.25%	\$285,313
429 N. State Of Franklin Rd., Johnson City, TN	12/21/2012	\$7,377,000	6.10%	\$449,997
4071 Lee Rd., Cleveland, OH	11/13/2012	\$4,800,000	7.74%	\$371,520
20 W. Main St., Brownsburg, IN	7/12/2012	\$3,520,000	8.34%	\$293,568
2001 Sunset Blvd., Steubenville, OH	6/15/2012	\$4,550,000	6.40%	\$291,200
775 Wenger Road, Englewood, OH	1/20/2012	\$4,735,000	7.76%	\$367,436
537 W. Main Street, Xenia, OH	10/31/2011	\$5,575,244	7.15%	\$398,630
1201 Getwell Road, Memphis, TN	10/26/2011	\$4,853,412	6.85%	\$332,459
1400 Cassapolis, Elkhart, IN	7/31/2011	\$5,040,000	6.75%	\$340,200
1801 N. Main Street, Madisonville, KY	6/29/2011	\$4,202,333	N/A	Not Leased
1415 Liberty Pike, Franklin, TN	5/12/2011	\$4,442,029	6.75%	\$299,837

	Cap. Rate
Range	5.75%-8.76%
Median	6.85%
Average	7.10%

Methodology of Net Leased Drugstore Valuation

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According to IRV, now that you have the Capitalization Rate, all you need is the Net Operating Income (NOI) in order to arrive at the value. In order to calculate the NOI you will need to see a copy of the lease. Below is a sample copy of a drugstore lease in Fayette County:

RENT

2. Tenant shall pay rent for the Leased Premises, as follows:

(a) (i) A fixed rent of \$29,729.17 per month, commencing on the Rent Commencement Date (as defined in Article 6), and continuing to and including the last day of the sixtieth (60th) full calendar month of the Term;

(ii) A fixed rent of \$30,562.50 per month, commencing on the first day of the sixty first (61st) full calendar month of the Term and continuing to and including the last day of the one hundred twentieth (120th) full calendar month of the Term;

(iii) A fixed rent of \$31,312.50 per month, commencing on the first day of the one hundred twenty first (121st) full calendar month of the Term and continuing to and including the last day of the one hundred eightieth (180th) full calendar month of the Term;

(iv) A fixed rent of \$32,062.50 per month, commencing on the first day of the one hundred eighty first (181st) full calendar month of the Term and continuing to and including the last day of the two hundred fortieth (240th) full calendar month of the Term;

This lease was initiated in 2000; as of Jan. 1, 2012 we were 137 months into lease term. This means monthly payments for this location would be \$31,312.50.

Annualized, this monthly payment results in a Potential Gross Income (PGI) of \$375,750. This is an indicated contract rent of \$24.85/sqft.

Methodology of Net Leased Drugstore Valuation

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Now that we have both a capitalization rate and an amount for income we can calculate the value.

In a 2008 KBTA case between a drugstore and Jefferson County, the two parties reached a settlement and the KBTA requested a stipulation of fact which stated that both parties agreed to use the following formula to value the property in question:

$$(\text{PGI} - 2\% \text{ Owners Expense}) / \text{Capitalization Rate} = \text{Value}$$

In this case the actual numbers work out to be:

$$(\$346,115 - \$6,922) / 7.5\% = \$4,522,573 \text{ or } \$4,500,000$$

Methodology of Net Leased Drugstore Valuation

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Using the formula, the value should only change for two reasons:

1. A change in the PGI
2. A change in the Capitalization Rate

The only time you will see a change in the PGI is when the lease has an escalation clause like the one pictured in the previous slide. Typically this number will increase and result in a higher value.

The second instance of change is seen more frequently as capitalization rates tend to fluctuate with the market. We are able to account for this through the use of comparable sales as well as the plethora of market information available.

Methodology of Net Leased Drugstore Valuation

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Now that we have all of the information we need and understand how the formula works, we are ready to value the property.

For this example I am going to use the following numbers:

$$\text{PGI} = \$375,750$$

$$\text{Expenses (2\%)} = \$7,515$$

$$\text{Capitalization Rate} = 7.25\% - \text{median rate from market data}$$

$$\begin{aligned} \text{Resulting Value} &= (\$375,750 - \$7,515) / 7.25\% \\ &= \$368,235 / 7.25\% \\ &= \$5,079,103 \\ &= \$5,100,000 \text{ (rounded)} \end{aligned}$$

Market Rent vs. Contract Rent

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One of the major problems in this case is whether or not to use the property's actual rent to establish value or to use market rent. The opinion of the PVA's office is to use the actual rent.

Using the market rent is the generally accepted method and is how we are taught to value properties in the courses provided by the Department of Revenue and the IAAO when calculating the **FEE SIMPLE** interest.

In the current Fayette County case, the appellant believes that the “market rent” should be defined as the rent for typical retail properties in the county. The PVAs disagree because the market for a national-chain drugstore is very specialized and exists on a much wider, national and even sometimes international scale.

Market Rent vs. Contract Rent

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In order to properly discuss this we will look back at the previous example.

In this example the contract rent was approximately \$24.85/sqft.

Let's say that for this particular area the "market rent/sqft" for retail properties is approximately \$18-20/sqft.

Below is a table indicating the difference in value when using market rent vs. contract rent:

	Contract Rent	Market Rent
\$/SF	\$ 24.85	\$ 20.00
Sqft.	15,120	15,120
Annual Rent (PGI)	\$ 375,732	\$ 302,400
Expenses (2%)	\$ (7,514.64)	\$ (6,048.00)
NOI	\$ 368,217	\$ 296,352
Capitalization Rate	7.25%	7.25%
Indicated Value	\$ 5,078,860	\$ 4,087,614
Value (Rounded)	\$ 5,100,000	\$ 4,100,000

Difference: \$1,000,000

Using this market rent would result in a **\$11,412 reduction** in revenue for Fayette County.

Market Rent vs. Contract Rent

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If we are supposed to use market rent then why aren't we valuing the property at \$4,100,000?

Simply put, the market has not been properly defined in this example. It is imperative that you understand the market for the typical drugstore property and compare that to the market for typical retail properties. The goal is to compare apples to apples and not apples to oranges. The previous example is an apples to oranges comparison.

Market Rent vs. Contract Rent

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In general, better credit tenants pay less than market rent but this is usually not the case when talking about the three major drugstore chains. Their rents are typically higher as an incentive to the developer to construct a specialized building that is essentially functionally obsolete when compared to typical retail properties.

This is why the construction cost of the drugstore property is a poor indicator of value and thus why we do not consider the cost approach an accurate means of valuation.

Market Rent vs. Contract Rent

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The fact of the matter is the typical purchaser of the drugstore property is purchasing based on the credit worthiness of the tenant (A+ for Walgreens, A for CVS, and B+ for Rite Aid)

A long term lease with a stellar credit tenant such as the A+ rated drugstore is much more valuable than a regular retail lease with a “Mom and Pop” retail tenant. This is due primarily to the default risk associated with the “Mom and Pop” retailer.

You never know when the “Mom and Pop” might go out of business and quit paying their rent. With the drugstore, you are guaranteed your rent payments over the life of the lease with very little risk of default.

Market Rent vs. Contract Rent

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A tenant's credit worthiness makes a difference in who might be willing to invest in this property.

The credit worthiness of the tenant also greatly affects the capitalization rate that is used when valuing the property.

An income stream from a tenant with a high credit ranking is less risky and therefore investors do not require as great a return on their money.

3rd Quarter 2012 – Net Lease Property Capitalization Rates

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THE NET LEASE MARKET REPORT

Q3 2013

MEDIAN ASKING CAP RATES BY YEAR BUILT

Tenant	2010-2013	2005-2009	2000-2004	Pre 2000
Walgreens	5.58%	5.80%	6.50%	7.50%
CVS	5.65%	6.03%	6.75%	7.25%
Rite Aid	N/A	8.10%	9.00%	9.15%
Advance Auto Parts	6.75%	6.90%	7.50%	8.80%
AutoZone	5.75%	5.95%	6.00%	N/A
O'Reilly Auto Parts	6.25%	6.48%	7.00%	8.50%
Dollar General	6.50%	8.00%	8.63%	8.88%
Family Dollar	7.53%	8.50%	8.60%	9.90%
McDonald's (GL)	4.10%	4.23%	4.43%	5.06%
FedEx	6.40%	7.50%	7.79%	8.75%
GSA	7.08%	7.13%	7.95%	10.25%
Chase (GL)	4.90%	5.00%	N/A	N/A
Bank of America (GL)	4.75%	5.63%	5.75%	N/A
Wells Fargo (GL)	4.88%	5.00%	5.25%	6.25%
7-Eleven	5.50%	5.80%	6.00%	6.58%
DaVita	6.25%	6.75%	7.40%	N/A
Fresenius	6.37%	7.15%	8.20%	N/A

This table indicates current asking capitalization rates for a number of popular net lease tenants. Although these are asking rates, actual rates derived from sales should fall close to these rates.

Note that the older the property is, the higher the cap rate. This is due to the remaining term on the lease.

Summary of Current Case

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The Subject Property

2290 Nicholasville Road, Lexington

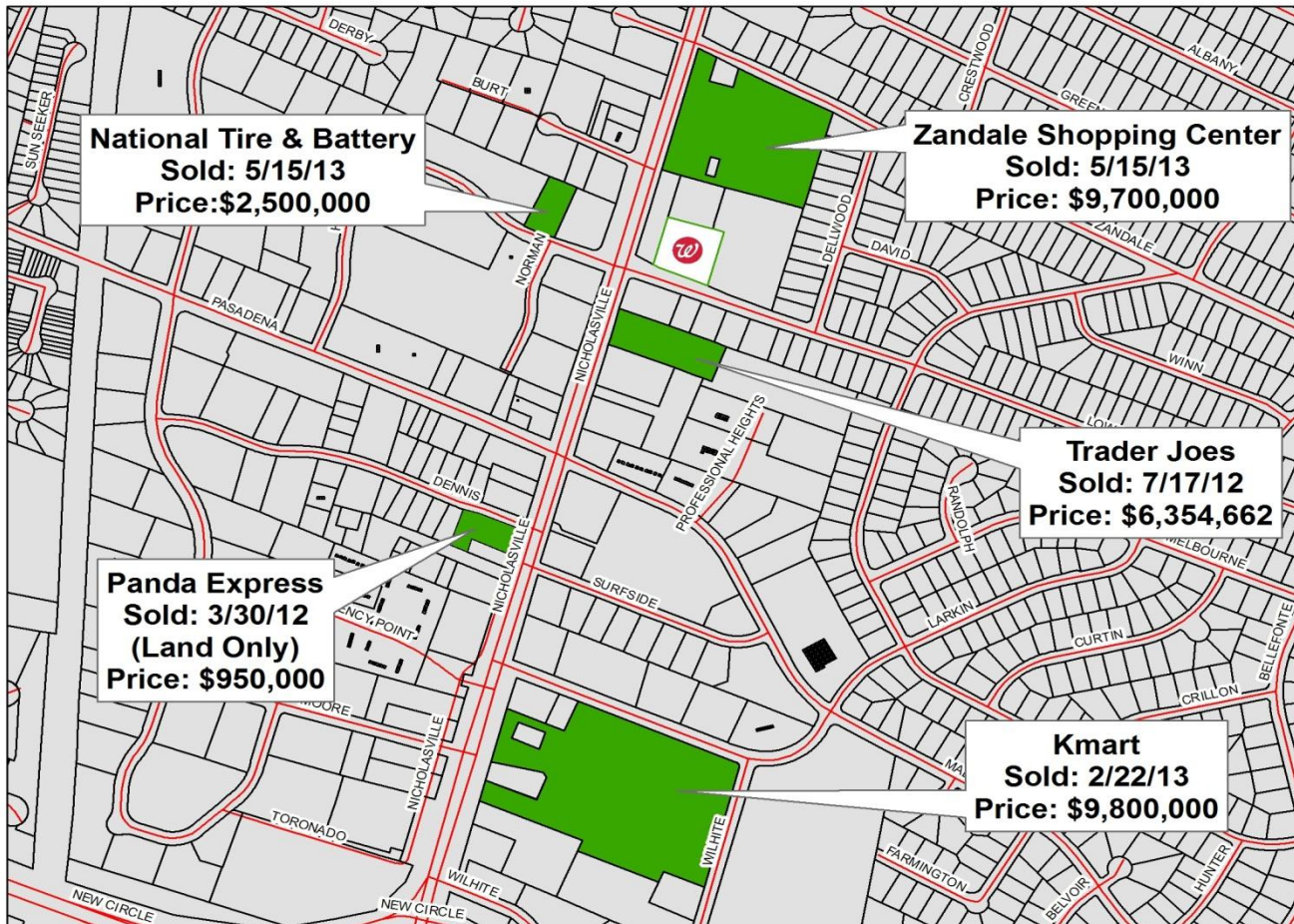


Summary of Current Case

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The Subject Property

2290 Nicholasville Road, Lexington



The Subject Property

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- Typical Walgreens build-to-suit store
- Built 2006 with 14,500 sf
- Site is 1.34 acres, zoned B-3 (Highway Service Business) on Nicholasville Road.
- Original owner paid \$437,000/acre to acquire the site in 2005.
- The property sold to Wilgreens, LLC. in February 2007 for \$6,275,000.
- The sales price was appealed for 2007, 2008, and 2009. These cases were settled with Wilgreens, LLC for \$5,250,000, \$5,086,000, and \$5,086,000 respectively.
- In 2012, Wilgreens appealed and declared \$4,397,600. For 2013, they appealed and declared a value of \$3,400,000.
- Walgreens has an appraisal that values this property at \$2,600,000.



The Subject's Lease

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- The lease is a 75-year triple net lease. The first option is after 25 years.
- The annual rent is \$402,243. It never steps up.
- Currently listed on LoopNet for \$6,995,530.
- A quick calculation using IRV indicates a 5.75% cap rate.



History of Assessed Values

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- (or “Why Settling Doesn’t Work”)
- The property sold to Walgreens, LLC. in February 2007 for \$6,275,000.
- The sales price was appealed for 2007, 2008, and 2009.
 - 2007: \$5,250,000
 - 2008: \$5,086,000
 - 2009: \$5,086,000
 - 2010: \$5,086,000
 - 2011: \$5,086,000
 - 2012: \$4,397,600 (declared)
 - 2013: \$3,400,000 (declared)
- Walgreens has an appraisal that values this property at \$2,600,000.
- In 7 years, \$10,533,400 in lost value.
 - \$105,334 @ 1% rate
 - \$68,500 to School
 - \$12,850 to KY

The Timeline

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- The cases for 2012 and 2013 were combined and the hearing was August 27 and 28, 2013 before all 3 members of the KBTA.
- The Chairman asked the attorneys to file briefs with the KBTA.
- The Appellants Brief has been filed.
- Fayette County's brief is due in December 2013.
- The Appellant has a Rebuttal Brief due in January 2014.
- After that, the KBTA will decide the case.
- We fully anticipate an appeal to the Circuit Court later in 2014.
- An appeal to the Supreme Court is a distinct possibility.

The Current Cases

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- In 2012, Walgreens filed 18 appeals in 7 counties:
 - Hopkins (2)
 - Scott (1)
 - Whitley (1)
 - Pulaski (1)
 - Campbell (1)
 - Fayette (5)
 - Jefferson (7).
 - **Total Value in Dispute: \$23,067,655**
- In 2013, Walgreens filed 22 appeals in 8 counties:
 - Hopkins (1)
 - Jefferson (9)
 - Fayette (7)
 - Campbell (1)
 - Oldham (1)
 - Bell (1)
 - Knox (1)
 - Scott (1)
 - **Total Value in Dispute: \$46,018,559**

*All information from KBTA website

Walgreens' Argument

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- Part of the Walgreens argument is that the PVA is assessing Leased Fee Value instead of Fee Simple Value.
- “A lease does not increase the fee simple value of a property.”—Appellant statement
- In other words, Walgreens is arguing that:
 - ▣ “Sticks and Bricks” + Land + Value of the Walgreens Lease = PVA Value.
 - ▣ The value of the lease is an intangible asset and cannot legally be assessed in KY.
- Walgreens suggests that PVA “suspend reality” (David Lenhoff) and assess the property at [local] market rates.
- The expert witnesses for Walgreens:
 - ▣ Glen Katz, MAI
 - ▣ Brian Rock, SRA
 - ▣ David Lenhoff, MAI (who is often cited in the 13th Edition of The Appraisal of Real Estate)

PVA Argument

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- Walgreens has created its own market on a national basis for these properties.
- The lease cannot be separated from the property as an intangible. Any entity which purchases the property will be subject to this lease.
- PVA used comparable sales and leases in the area which support Walgreens' assessed value and lease rate.
- Funding for this case was provided by several school boards. In Fayette County alone, we were able to show our school board the following:
 - ▣ 7 stores @ \$2,000,000 reduction in value each = \$14,000,000 value lost
 - ▣ \$14,000,000 at 1% tax rate = \$140,000 PER YEAR in lost revenue
 - ▣ My board of education gets 65% which is \$91,000 income lost EACH YEAR.
 - ▣ You might try this approach in your own county now that the precedent is set.
- The Expert Witnesses for PVA:
 - ▣ David Donan, MAI
 - ▣ Jamie Schrader, Commercial Real Estate Broker
 - ▣ Justin Stevens, Commercial Real Estate Broker

KBTA Decision Possibilities

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- The Good
 - ▣ KBTA rules in our favor

- The Bad
 - ▣ KBTA rules in Walgreen's favor

- The Ugly
 - ▣ Either party wins but no precedent set

Board Decision-Walgreen's Loses

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□ Advantages

- ▣ All properties under lease agreement can be assessed based upon the contractual income that is in place.
- ▣ Many properties such as Walgreen's, CVS, Rite-Aid, and other triple net leased properties can have significant assessment increases based upon market data (sale prices, income capitalization).

□ Disadvantages

- ▣ Properties under lease agreement may have a below market lease that will require a decrease in the assessed value even though they may be on a short term lease.
- ▣ Income producing properties that have higher than normal vacancy will appeal based upon the contractual income collected for the specific tax year. A reduction in assessed value may be granted, but the property will require inspection each year to determine if the vacancy amount has been reduced and if a reassessment is warranted.

Board Decision-Walgreen's Wins

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□ Advantage

- All income producing properties will be based upon market rates regardless of their contractual income and operating statements which will make it easier to do mass reassessment and also give credible support during appeals.

□ Disadvantage

- Many income producing properties like Walgreen's will appeal their assessment to reflect a fee simple value using local market rates which would most likely be lower than the current assessment

Board Decision-

Either Wins but no precedent is set

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- Nobody wins and there will still be considerable confusion and the current way to assess property by either fee simple or leased fee for income producing properties

Conclusion

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- Please do not settle a Walgreens case or other types of triple net leased properties in your county until a final decision is determined.
- Please do not “suspend reality” and assess the property at [local] market rates.
- Win or lose, hopefully we will have a decision to guide us in determining a value, but this decision will not be soon.

Questions?

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If you have any questions concerning the material in this presentation or about the valuation of net leased properties, please contact us:

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